OUTLOOK

A Publication Of The South Dakota Retirement System

Number 4 **December 2008**

Investment Earnings Tumble

SDRS Not Immune to Market Turmoil

It's been a dismal season for the stock market. Investors everywhere have suffered losses, and SDRS is no exception. As of October 1, 2008, the SDRS trust fund had lost 25 percent of its value.

"While this decline is dramatic," says SDRS' executive director and administrator, Rob Wylie, "it's far less than the losses in the overall market. Between October 2007 and mid-November 2008, the Dow Jones Industrial Average fell more than 6,500 points, losing nearly half its value."

> *". . . the SDRS Board of Trustees has determined that no changes to the system's benefit structure or cost-of-living allowance will be necessary in this legislative session."*

Although SDRS has not been exempt from the influence of falling financial markets, its underlying fiscal strength has muted the consequences of the crisis. "At the beginning of the decline, SDRS had nearly $2 billion in its reserve," says Wylie. "That exceptionally strong financial position blunted the negative effect on the assets we use to pay promised benefits."

As a result, the SDRS Board of Trustees has determined that no changes to the system's benefit structure or cost-of-living allowance will be necessary in this legislative session. Wylie says that the Board is carefully monitoring the capital markets and will take action if the financial integrity of the system is threatened.

Pension payments rely on market returns

Investment performance is important since SDRS, like other pension systems across the country, depends on investment income to pay benefits. SDRS requires long-

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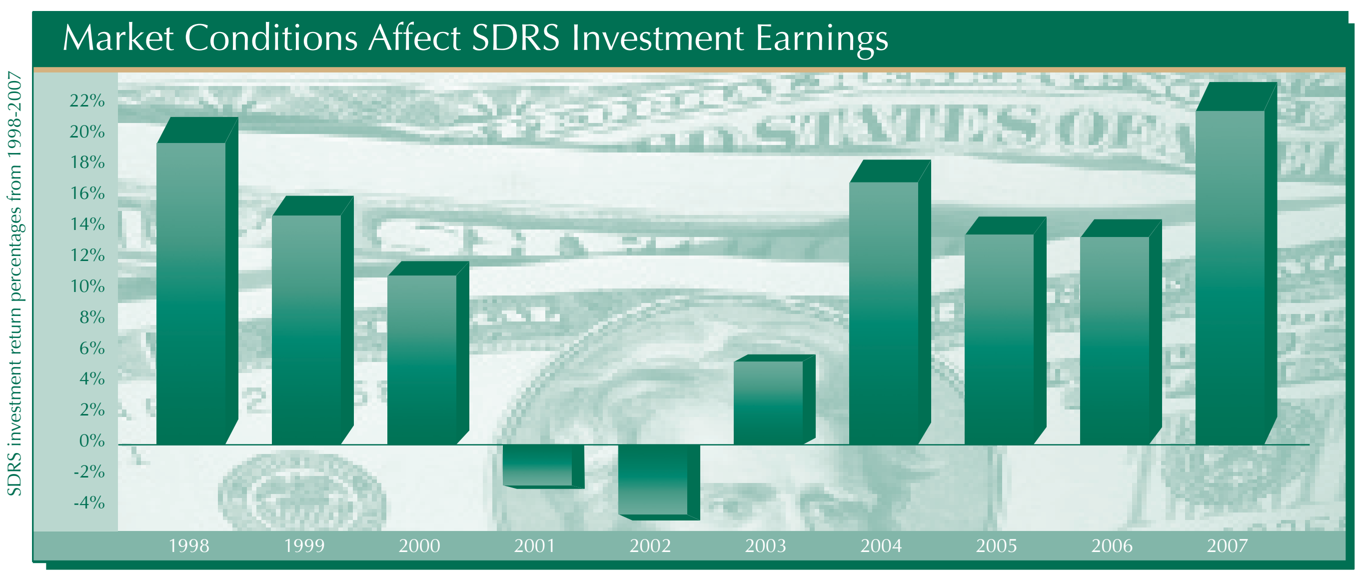
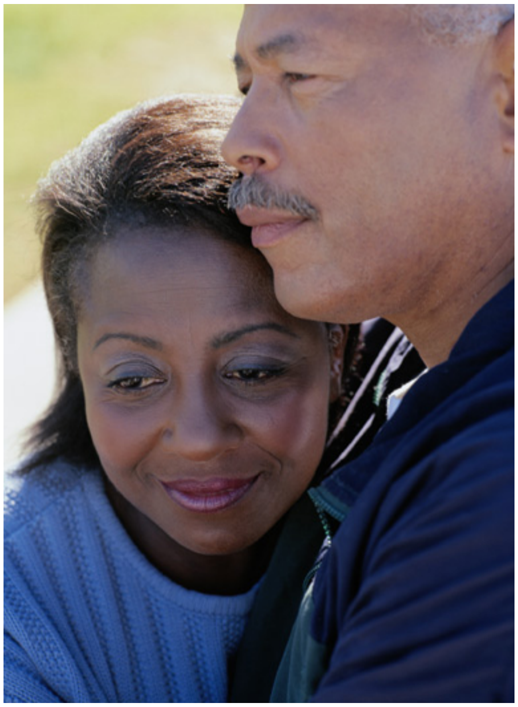


SDRS earnings are affected by the performance of financial markets. The record of SDRS' investment returns over the past decade illustrates why SDRS has been well able to weather the current crisis, with annual returns exceeding the assumed rate of 7.75 percent helping to protect the system during years of weak earnings.

Value Proven in Times of Falling Markets

Reserve Has Shielded System in Past



Markets go up, markets go down. Good times don't last forever, and neither do bad. Recognizing these economic truisms, in 1995 SDRS established a reserve to protect the system from fluctuations in the financial markets. In good times, when investment earnings exceed expectation, money is deposited in the reserve. When markets fall, the reserve is used to bridge the gap between weak returns and the level of earnings required to balance income with liabilities. When the reserve is sufficiently robust, it also prepays benefit improvements.

Within five years of its creation, the reserve proved its value. Between 2000 and 2002, following the bursting of the dot-com bubble, U.S. financial markets plummeted. The Dow Jones Industrial Average, a key indicator of market performance, lost more than one third of its total value. But because SDRS could draw on its reserve, it was able to manage the downturn. Despite investment losses, the system sustained its financial viability and emerged from that bear market as one of the best-funded public pension systems in the nation.

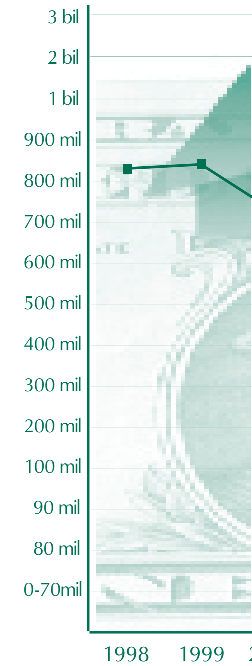
Rising market refurbishes reserve

The experience of 2000-2002 exhausted the reserve, but in the following five years, returns again exceeded expectations. SDRS used these strong earnings to build the reserve back up. In fact, investment results were so positive that in 2007 the SDRS Board exercised the second purpose of the reserve and approved a benefit increase. By June 30, 2007, the reserve was over $2 billion.

Since that date financial markets worldwide have plunged in value. SDRS used the reserve to ward off the effects of this global crisis on the assets the system uses to pay benefits. There is no way to be certain how long the current crisis will last, nor how deep it will be. But past experience indicates that over time SDRS will be able to weather this difficult period and will restore its reserve as the markets rebound in the future. OUTLOOK

Record Shows Reserve Respondin

Reserve levels rise and fall as SDRS uses the dollars to provide benefit improvements and to cushion the system when investments earnings are less than anticipated. Fluctuations in its dollar amount demonstrate that the reserve is performing its job.



You Should KN

Measuring the Heal

"A healthy pension system holds a ratio of assets to liabilities of at least 80 percent"

Pension systems employ long-term investment strategies, allowing them

Outlook is produced to communicate the plan provisions, change
government, state employees, county commissions, county emplo

g to SDRS Needs

SDRS Not Immune to Market Turmoil *continued*

term average earnings of 7.75 percent — its assumed rate of return — to balance income and benefits.

Fortunately, because promised benefits come due over decades and not all at one time, a pension system can normally weather market fluctuations. Strong returns in one year can compensate for poor returns in another. Generally systems' investment strategies are based on a time horizon of 10 to 20 years, long enough to allow bull markets to even out the effects of market downturns.

However, no system, including SDRS, can withstand erosion of its financial condition indefinitely. If average investment income stays below the assumed rate of return for a lengthy period of time, a pension plan must confront imbalances between assets and liabilities to stay solvent.

The bottom line is long-term

While retirement plans across the country expect investment losses to even out over time, they also have a fiduciary responsibility to consider their options in case the pendulum doesn't swing back. "It's not too early to begin looking at worst case scenarios and conducting 'what if,' discussions" says Wylie. "We're hopeful about a favorable outcome in the long term, but we recognize that the economy is in uncharted waters."

History demonstrates that markets do recover, and that retirement plans that are fundamentally sound and prudently governed are best able to withstand an economic crisis. "Although SDRS members are not exempt from the pain experienced throughout the nation," says Wylie, "they have cause for a level of optimism than few others can justify when looking toward their retirement future."

IOW…

th of Pension Funds

to even out differences between strong and weak annual investment returns. For example, earnings in the five years following the bear market of 2000-2002 more than made up for those two years of poor performance. Most systems were markedly better funded in 2007 than they were in 2002.

According to the National Association of State Retirement Administrators, a healthy pension system holds a funded status — its ratio of assets to liabilities — of at least 80 percent. As of July 2008, public employee pension funds nationwide held on average 90 cents for each dollar they owed. By comparison, as of July 2008 SDRS had 105 cents in its trust fund for each dollar promised in benefits.

Data tallying recent pension system performance are not yet available, but many funds report losing over a quarter of their assets since the onset of the economic tumult.

How well pension systems survive depends on their financial structure and investment prudence as well as on the length and depth of the downturn. The threat is least grave to those systems — like SDRS — which held a high ratio of assets to obligations at the onset of the crisis.

s in law, and issues of interest to the members of the South Dakota Retirement System. It is published with funds provided through the contributions of teachers, school boards, state
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Setting aside dollars to improve benefits, safeguard the system

$1 Billion Reserve Cushions Blow of Plunging Stock Prices

SDRS reserves absorbed a sizeable amount of the financial shock caused by the crisis on Wall Street. Created with investment earnings, the reserve cushioned the effect of SDRS' losses since July 1, 2007. "Without the reserve, SDRS would have a much bigger gap between the amount of its assets and the sum of the benefits it will pay out over the long term," says Board Chairman Elmer Brinkman. "While it couldn't protect the system from all the effects of the economic crisis, it's done its job."

The reserve has two purposes:

- to safeguard the system when investment earnings fall below 7.75 percent (the long-term average amount needed to fund the base benefit)
- to prepay benefit improvements

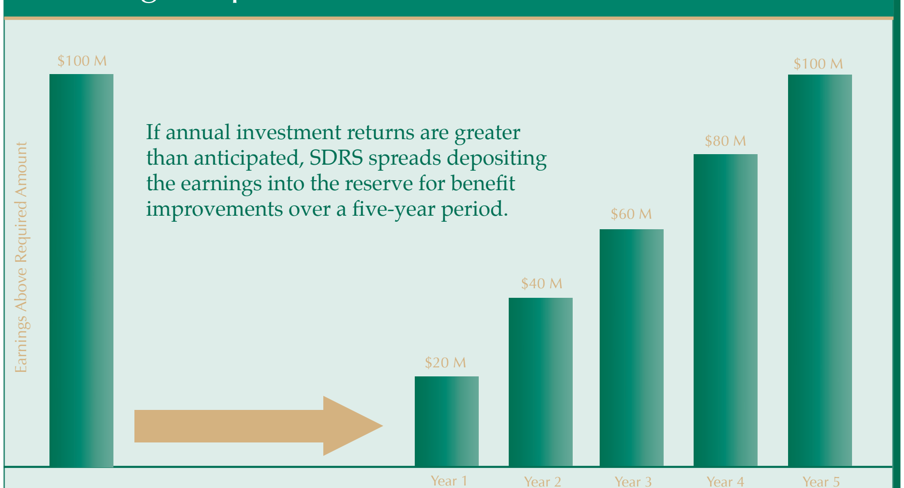
How the reserve works

In the years when SDRS earnings are over 7.75 percent, the unanticipated dollars are put into the reserve. They are not, however, immediately eligible for benefit improvements—that occurs over a staggered five-year period.

For example, if in one year SDRS earns $100 million above the required amount, $20 million would be eligible for benefit improvements in the first year, $20 million in the second year and so on. The Board will only consider benefit improvements when the total dollars in the reserve reach a predetermined amount. In the meantime, the reserve is protecting the system from the normal ups and downs in investment returns as well as from steeper declines such as the system is experiencing today.

The illustration below shows the conservative, five-year approach used by SDRS to fund benefit improvements while still protecting the system.

Earnings Deposited into the Reserve Over Five Years



Board Notes

The following is a summary of major issues that came before the SDRS Board of Trustees at its meeting on December 3-4, 2008.

December 3-4, 2008

Reports and discussions

Wade Hubbard, SDRS' legal counsel, presented recommendations concerning brand investigators, Brule County jailers, Beadle County jailers and Davison County jailers as Class B Public Safety members.

Rob Wylie, SDRS' administrator, conducted an executive session to discuss consultant contracts.

Buck Consultants joined Wylie in presenting reviews of the optional spouse benefit and of considerations regarding retirees returning to work.

Wylie and Hubbard discussed the Board's fiduciary responsibility and final legislative considerations. Paul Schrader, a consultant, joined Wylie to discuss statutory conditions that would require corrective action.

Financial status and budget

For the period ending June 30, 2008, Wylie and Jane Roberts, SDRS' chief financial officer, presented financial statements; and David Slishinsky and Douglas Fiddler, from Buck Consultants, presented the actuarial valuation.

Roberts presented the Governor's recommended FY 2010 budget for SDRS and the Board approved it.

Present: Elmer Brinkman, chair; Brian Berglin; Jason Dilges; Cathy Druckrey; Laurie Gustafson; James Johns; James Hansen; Ray Hofman; Chuck Holmstrom; Louise Loban; K.J. McDonald; Eric Stroeder; Mike Turnwall; Sandy Zinter; Justice Steve Zinter; Matt Clark, ex officio

Absent: Darwin Longielière

Global Crisis Raises Question of Benefit Reductions

"The questions are, how deep will the crisis be and how long will it last."

Although the SDRS Board of Trustees will not be recommending a change in benefits to the 2009 Legislature, the magnitude of the global financial crisis has brought the issue to the forefront. While SDRS customarily describes benefits as "guaranteed," it is also legally bound to take corrective action if its financial integrity is threatened. In addition, the improvement in the benefit formula that became effective on July 1, 2008 contained a provision by which the improvement could be suspended in a financial crisis.

During its December meeting, the Board began an analysis of the current threat to SDRS and the system's options if present economic conditions continue. "No one wants to reduce benefits," says Rob Wylie, SDRS' administrator, "and certainly no one wants the system to fail. The questions are, how deep will the crisis be and how long will it last." As the world awaits the answers, the Board will continue to monitor events and consider its options.

OUTLOOK *Interview*

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some segments of the market before, but in the last 60 years it's never been this pervasive in the U.S. and global economies.

OUTLOOK: So you're saying a cause of Wall Street's crisis is the high level of debt among individuals, financial institutions and corporations?

CLARK: It's a major factor. Millions of Americans are living with mortgages they can't afford and credit card balances they can't pay off. Some of our largest financial institutions were lending $30 for every $1 they had in equity. Now that the bubble has burst there just aren't a lot of people or institutions left with the money and the will to take advantage of bargain prices on Wall Street. As a consequence, prices have declined more than at any time since the great depression.

OUTLOOK: Are you saying that the market could drop even further?

CLARK: The expectations of the analysts we pay attention to range anywhere from 10 percent to 50 percent, depending on how quickly confidence in the system can be restored. After that, they expect the recovery to begin.

OUTLOOK: What do you think?

CLARK: Prices could certainly fall further, but we believe there are exceptional opportunities right now for those who have the patience to take a long-term view. We strongly agree with Warren Buffet when he says that he attempts to be fearful when others are greedy and greedy when others are fearful.

OUTLOOK: What needs to happen to turn our economy around?

CLARK: Our country strayed by becoming a debt-based society. Debt fueled an illusion that our economy was stronger than it really was and that a standard of living based on borrowing could be sustained forever. To turn things around will require a number of things. We'll need to unfreeze the credit markets because the economy cannot function without credit. In my view, this will require significant commitment from the government to fill the lending void until investors regain confidence in the system. Interest rates will need to be very low until fear of deflation subsides. We will need a very large stimulus to keep the economy functioning in the short term, and we'll need to restore reasonable levels of regulation in our financial markets. It will also be critical that we resist imposing barriers to free trade and to refrain from raising business taxes.

Most of all we need to restore our confidence in the power of our strong work ethic, entrepreneurialism and innovation. The optimism that can come with new leadership may be helpful here. It may not happen quickly, but good decisions explained clearly by individuals we trust will move us toward a critical mass of optimism. At that point, as has always happened in the history of our country, the allure of bargain prices will again matter and the markets will begin to recover.

South Dakota Retirement System
P. O. Box 1098
Pierre, South Dakota 57501

"... we believe there are exceptional opportunities right now for those who ... take a long-term view."

Matt Clark

OUTLOOK Interview

Matt Clark is the South Dakota Investment Council's investment officer and a member of the SDRS Board of Trustees. SDRS benefits are financed in part with the investment earnings of the system's trust fund. The Investment Council is the investment manager for SDRS. In the following interview, Mr. Clark discusses the crisis on Wall Street.

As of mid-November, the global stock markets are down about 35 percent from June 30 of this year. By comparison, total returns on the SDRS trust fund are down approximately 25 percent for the same period.

OUTLOOK: In hindsight, were there clues that stock prices might decline so dramatically, or was it inevitable that the crisis would be a complete surprise?

CLARK: It wasn't the decline that surprised us but the severity of it. We thought markets were becoming expensive in early 2007, so we reduced our exposures somewhat. When the markets fell below long-term fair value in March 2008, we increased our exposure to normal levels. By mid-July 2008, markets had fallen to a level we expect only once every twenty years. At that point, we increased our investment in stocks and other depressed assets to the extent our diversification guidelines allow. Since then the markets have declined to a point that we would expect to see once in every forty years. We have continued to add modestly to our stocks and other assets as they have fallen in price.

OUTLOOK: What did the investment industry miss in its analysis of economic conditions?

CLARK: We understood that lenders were using relaxed standards to make mortgages, but we and others underestimated how lax those standards had become and the magnitude of abuse. Easy credit resulted in borrowers increasing their level of debt until they could only pay back their loans if real estate prices continued to rise. We've seen this level of debt and speculation in

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NOTICE TO INTERESTED PARTIES

1. Notice To: Members of the South Dakota Retirement System

An application is to be made to the Internal Revenue Service for a determination on the continued qualification of the following employee pension benefit plan:

2. South Dakota Retirement System

3. Plan Number: 001

4. Applicant: South Dakota Retirement System Board of Trustees
P.O. Box 1098
Pierre, SD 57501

5. South Dakota Retirement System Employer Identification Number: 46-6000364

6. Plan Administrator: Robert A. Wylie
South Dakota Retirement System
P.O. Box 1098
Pierre, SD 57501

7. The application will be filed on January 31, 2009, for a determination as to whether the plan meets the qualification requirements of section 26 USC 401 of the Internal Revenue Code of 1986, with respect to plan amendments. The application will be filed with:
EP Determinations
Internal Revenue Service
P.O. Box 192
Covington, KY 41012-0192

8. The employees eligible to participate under the plan are full-time employees of South Dakota state or local government units that participate in the plan.

9. The Internal Revenue Service previously has issued two favorable determination letters with respect to the qualification of this plan.

RIGHTS OF INTERESTED PARTIES

10. You have the right to submit to EP Determinations, at the above address, either individually or jointly with other interested parties, your comments as to whether this plan meets the qualification requirements of the Internal Revenue Code. You may instead, individually or jointly with other interested parties, request the Department of Labor to submit, on your behalf, comments to EP Determinations regarding qualification of the plan. If the Department declines to comment on all or some of the matters you raise, you may, individually, or jointly if your request was made to the Department jointly, submit your comments on these matters directly to EP Determinations.

REQUESTS FOR COMMENTS BY THE DEPARTMENT OF LABOR

11. The Department of Labor may not comment on behalf of interested parties unless requested to do so by the lesser of 10 employees or 10 percent of the employees who qualify as interested parties. The number of persons needed for the Department to comment with respect to this plan is 10. If you request the Department to comment, your request must be in writing and must specify the matters upon which comments are requested, and must also include:

(1) the information contained in items 2 through 5 of this Notice; and

(2) the number of persons needed for the Department to comment.

A request to the Department to comment should be addressed as follows:

Deputy Assistant Secretary
Employee Benefits Security Administration
ATTN: 3001 Comment Request
U.S. Department of Labor
200 Constitution Avenue, NW
Washington, DC 20210

COMMENTS TO THE INTERNAL REVENUE SERVICE

12. Comments submitted by you to EP Determinations must be in writing and received by it by March 17, 2009. However, if there are matters that you request the Department of Labor to comment upon on your behalf, and the Department declines, you may submit comments on these matters to EP Determinations to be received by it within 15 days from the time the Department notifies you that it will not comment on a particular matter, or by March 17, 2009, whichever is later, but in no event later than April 1, 2009. A request to the Department to comment on your behalf must be received by it by February 15, 2009, if you wish to preserve your right to comment on a matter upon which the Department declines to comment, or by February 25, 2009, if you wish to waive that right.

ADDITIONAL INFORMATION

13. Detailed instructions regarding the requirements for notification of interested parties may be found in sections 17 and 18 of Rev. Proc. 2007-6. Additional information concerning this application (including, where applicable, an updated copy of the plan and related trust; the application for determination; any additional documents dealing with the application that have submitted to the Service; and copies of section 17 of Rev. Proc. 2007-6 are available at 222 E. Capitol Avenue, Suite 8, during the hours of 8:00 a.m. CST to 5:00 p.m. CST for inspection and copying.